Nos. 22,397 and 22,398

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

UNITED STATES OF AMERICA,

Appellant

v.

CALIFORNIA PORTLAND CEMENT CO.,

Appellee

ON APPEALS FROM THE JUDGMENTS OF THE UNITED STATES DISTRICT COURT FOR THE CENTRAL DISTRICT OF CALIFORNIA

BRIEF FOR THE APPELLANT

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Miscellaneous (continued)

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BRIEF FOR THE APPELLANT

OPINION BELOW

The findings of fact and conclusions of law of the District Court (No. 22,397, I-R. 119-130; No. 22,398, I-R. 176-191) are not officially reported.

JURISDICTION

These appeals involve federal corporate income taxes and excess profits taxes paid by the taxpayer for its taxable years ended April 30, 1953, April 30, 1954, April 30, 1955, April 30, 1956, April 30, 1957, April 30, 1958, and April 30, 1959 (No. 22,398, I-R. 177), and federal corporate income taxes and excess profits

taxes paid by taxpayer's predecessor in interest, Arizona Portland Cement Company, for its taxable years ended April 30, 1953, April 30, 1954, April 30, 1955, April 30, 1956, and April 30, 1957 (No. 22,397, I-R. 120-121). Arizona Portland Cement Company was merged into taxpayer on August 31, 1961, and taxpayer thereby succeeded to the rights of Arizona Portland Cement Company under its pending claims for refund. (No. 22,397, I-R. 120.) The taxes in dispute were timely paid and claims for refund were timely filed.[1/] Within the time provided by Section 3772 of the Internal Revenue Code of 1939 and Section 6532 of the Internal Revenue Code of 1954, on June 2, 1965, the taxpayer brought these actions in the District Court for recovery of the taxes paid by itself and by its predecessor in interest, Arizona Portland Cement Company. (No. 22,397, I.R. 2; No. 22,398, I-R. 2.) Jurisdiction was conferred on the

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1/ This jurisdictional statement would be extended to an inordinate length by a particularization of the dates and amounts of the payments and the dates on which the various claims for refund were filed and successively amended. For the dates and amounts of the payments by taxpayer which the District Court has ordered refunded, see No. 22,398, I-R. 190-191. For the dates and amounts of the payments of Arizona Portland which the District Court has ordered refunded to taxpayer as Arizona Portland's successor in interest, see No. 22,397, I-R. 129-130. The dates on which taxpayer's claims for refund were filed and successively amended, the timeliness of such filings and amendments, and the timeliness of the suit for refund, the claims having neither been allowed nor disallowed, have all been stipulated. (No. 22,398, I-R. 135, 145-146, 148-149, 151-152, 154-162.) These matters are likewise stipulated as to Arizona Portland's claims for refund and the suit thereon. (No. 22,397, I-R. 90, 97-99, 101-105, 107-110.)

District Court by 28 U.S.C., Section 1346. The judgments of the District Court were entered on March 23, 1967. (No. 22,397, I-R. 147; No. 22,398, I-R. 225.) On April 3, 1967, the Government filed motions for amendment of the findings and judgments and for a rehearing. (No. 22,397, I-R. 151; No. 22,398, I-R. 226.) These motions were denied on July 31, 1967. (No. 22,397, I-R. 162; No. 22,398, I-R. 237.) Within sixty days thereafter, on September 28, 1967, the Government filed its notices on appeal. (No. 22,397, I-R. 163; No. 22,398, I-R. 238.) Jurisdiction is conferred on this Court by 28 U.S.C., Section 1291.

QUESTIONS PRESENTED

Under the cost-oriented proportionate profits method, concededly applicable here, the depletable mining income of an integrated miner-manufacturer is the portion of its total gross income from the manufactured product which is produced by mining costs, and this portion is determined by the ratio of mining costs to the total costs (mining and non-mining) which produced the total gross income.

The questions presented are whether the District Court has erroneously interpreted and applied the proportionate profits method in the following respects:

1. In allocating to mining costs the expenses of handling

and storing purchased mineral materials (additives) prior to their addition to the kiln feed.

2. In excluding from the computation the income from sales of bagged cement, the costs producing such sales and certain selling expenses.

3. In failing to include the costs of bags and bagging and the selling expenses as non-mining costs in their entirety.

4. In allocating between mining and non-mining income an inflated gross income figure based on list prices rather than on the actual receipts produced by the so-called discount prices.

STATUTES AND OTHER AUTHORITIES INVOLVED

The statutes and other authorities involved are set forth in Appendix A, *infra*.

STATEMENT

The material facts, as found by the District Court (No. 22,397, I-R. 120-127; No. 22,398, I-R. 176-187), may be summarized as follows:

During the taxable years involved, taxpayer was a California corporation with its principal offices in Los Angeles, and Arizona Portland Cement Company (hereinafter "Arizona Portland") was an Arizona corporation with its principal offices in Tucson, Arizona. Both corporations kept their books and filed their returns on the basis of a taxable year ended April 30 and the accrual method

of accounting. Arizona Portland was merged into taxpayer on August 31, 1961, and taxpayer thereby succeeded to the rights of Arizona Portland under its pending claims for refund for its fiscal years ended April 30, 1953-April 30, 1957. (No. 22,397, I-R. 120-121; No. 22,398, I-R. 176-177.)

The principal business of both corporations during the taxable years was the manufacture and sale of finished cement (Portland and allied types). Taxpayer conducted this business in its plant at Colton, California, and (commencing in the taxable year ended April 30, 1956) in its plant at Mojave, California. Taxpayer owned a deposit of calcium carbonate rock (limestone) immediately adjacent to its Colton plant and another immediately adjacent to its Mojave plant. Arizona Portland manufactured cement in its plant at Rillito, Arizona, immediately adjacent to which the corporation owned a deposit of calcium carbonate rock (limestone). Taxpayer and Arizona Portland extracted the calcium carbonate rock from the said deposits and produced cement clinker and finished cement from such rock in the adjacent plants by the application of the ordinary treatment processes normally applied by mine owners and operators in the cement industry having similar deposits. (No. 22,397, I-R. 121; No. 22,398, I-R. 177-178.)

At no time during the taxable years was there any commercial market for the calcium carbonate rock extracted and used by the

corporations in manufacturing cement, within the market areas respectively available to taxpayer and Arizona Portland, at any stage of extraction or processing (apart from minor sales of cement clinker) prior to the production of finished cement. The corporations supplied only a portion of the demand for finished cement in the market areas respectively available to them. (No. 22,397, I-R. 122-123; No. 22,398, I-R. 182.) Taxpayer sold an average of 4.9 per cent of its cement clinker, during the taxable years, to Blue Diamond Corporation. Arizona Portland sold approximately 2.6 per cent of its cement clinker, during the taxable year ended April 30, 1957, to Southwestern Portland Cement Company. Blue Diamond and Southwestern Portland were the only concerns, within the market areas respectively available to taxpayer and Arizona Portland, which purchased cement clinker for production of finished cement. There was no commercial market, within the said market areas, for any additional amounts of clinker or for any mineral product of like kind and grade at any earlier stage of extraction and processing. The clinker sold by the corporations could not have been produced and sold on a commercial basis except as by-products incident to the corporations' cement-producing operations, and the sales did not establish any representative market or field price for the calcium carbonate rock used by the corporations in producing cement. (No. 22,397, I-R. 121-122; No. 22,398, I-R. 180-181.)

In its Colton plant taxpayer used limited amounts of calcium carbonate rock extracted from its adjacent deposit to produce ground rock for sale as glass sand, poultry grits, roofing grits and miscellaneous purposes; to produce finished lime products (lump lime, ground quicklime and hydrated lime); and to produce paving dust (fines). The calcium carbonate rock so used was not of like kind and grade to the calcium carbonate rock used by taxpayer in its principal business, producing and selling cement. The ground rock, lime products and paving dust could not have been produced and sold by taxpayer on a commercial basis except as by-products incident to taxpayer's cement-producing operation, and the sales of such by-products did not establish any representative market or field price for the calcium carbonate rock used by taxpayer in producing cement. (No. 22,398, I-R. 178-181.)

The calcium carbonate rock extracted by the corporations from their deposits had an average total carbonates content of approximately 80 per cent, and were not "marble" but "limestone" or "calcium carbonates" within the commonly understood meaning of those terms. It was not economically or commercially feasible for taxpayer or Arizona Portland to use any of their calcium carbonate rock in the production of dimension stone. (No. 22,397, I-R. 122; No. 22,398, I-R. 181.)

In their cement-producing operations, taxpayer and Arizona Portland added iron ore and quartzite to their calcium carbonate

rock in the raw grinding stage prior to the introduction of the raw mix into the kiln. The addition of these mineral materials was an essential step in the production of their cement clinker and finished cement. Subsequent to the corporations' acquisition of the iron ore and quartzite, but prior to their admixture with the calcium carbonate rock, these mineral materials were stored on the corporations' premises and then moved to the point of admixture. (No. 22,397, I-R. 123; No. 22,398, I-R. 182-183.)

In the context of the foregoing primary findings, the District Court entered a conclusory finding that the corporations' costs of storing and handling the purchased mineral materials, prior to their admixture with the calcium carbonate rock, should be treated as mining costs. (No. 22,397, I-R. 123; No. 22,398, I-R. 183.) The Government contends that this finding is erroneous as a matter of law.

Taxpayer and Arizona Portland offered to their customers, after sale, a discount of 20 cents per barrel of finished cement. Taxpayer offered a similar discount with respect to its paving dust and ground calcium carbonate rock. (No. 22,387, I-R. 123; No. 22,398, I-R. 182.)

With respect to these discounts, the District Court entered a finding that they were offered for the purpose of inducing prompt payment and not for the purpose of inducing sales, and were cash

discounts rather than trade discounts. (No. 22,397, I-R. 123; No. 22,398, I-R. 182.) The Government contends that this finding is unwarranted by the record and erroneous.

In November, 1960, timely elections were filed by taxpayer and Arizona Portland to have the provisions of Section 302(b) of the Public Debt and Tax Rate Extension Act of 1960, Appendix, infra, apply to the computation of their percentage depletion allowances for all open taxable periods, which included the taxable years involved in this litigation. Their depletion allowances for the taxable years with respect to their calcium carbonate rock used in the production of cement clinker and finished cement are to be computed under the proportionate profits method prescribed in Treasury Regulations 118, Section 39.23(m)(e)(3), Appendix, infra, by reference to a cutoff at the kiln-feed point after mixing and grinding. (No. 22,397, I-R. 124; No. 22,398, I-R. 183-184.)

The District Court entered a conclusory finding that the "first commercially marketable product" of the corporations' cement-producing operations was bulk cement, and that both the additional income and the additional costs attributable to sales in sacks should be excluded from the computation of the corporations' depletion allowances. (No. 22,397, I-R. 124-125; No. 22,398, I-R. 184-185.) The Government contends that this finding is erroneous as a matter of law.

During the taxable years, taxpayer and Arizona Portland incurred certain selling expenses with respect to their products, consisting primarily of salaries and other expenses of salesmen, and membership in various industry trade associations. (No. 22,397, I-R. 125; No. 22,398, I-R. 185.)

The District Court entered a conclusory finding that because, in its view, the said selling expenses did not "represent the cost of any process" applied to the corporations' calcium carbonate rock, they should be excluded from the computation of the corporations' depletion allowances. Alternatively, the court found that, if the computation under the proportionate profits method prescribed in Regulations should include costs other than "direct process costs", the selling expenses should be allocated "to both the mineral product and the manufactured product because such expenses were necessary to and of benefit to both such products". (No. 22,397, I-R. 125; No. 22,398, I-R. 185.) The Government contends that these findings are erroneous as a matter of law.

The District Court entered conclusions of law in accordance with its findings (No. 22,397, I-R. 127-130; No. 22,398, I-R. 188-191), and judgments in favor of taxpayer in the amounts of $93,618.38 and $240,244.99, with statutory interest (No. 22,397, I-R. 147; No. 22,398, I-R. 225).

SPECIFICATION OF ERRORS RELIED UPON

The Government contends that the District Court erred in the following respects:

1. (a) In ruling that the costs of storing and handling purchased or fully depleted mineral materials, prior to their addition to the kiln feed, were costs of mining processes as defined by the applicable statutory provisions; and (b) in allocating such expenses, in the proportionate profits computation, to mining costs.

2. (a) In ruling that the "first commercially marketable product" was bulk cement only, notwithstanding the fact that the finished cement was sold both in bulk and in bags; (b) in excluding the income from sales of bagged cement, and the costs producing such sales, from the proportionate profits computation; and (c) in failing to include such costs in the computation as non-mining costs in their entirety.

3. (a) In ruling that certain expenses of selling the finished cement (primarily the salaries and other expenses of salesmen and membership in trade associations) should be excluded from the proportionate profits computation; and (b) in failing to include such expenses in the computation as non-mining costs in their entirety.

4. (a) In ruling that discounts to customers were offered exclusively for the purpose of inducing prompt payment, and not for the purpose of inducing sales, although the so-called discount

prices were set in competition with other members of the cement industry and produced the corporations' actual receipts; and (b) in allocating between mining and non-mining income, in the proportionate profits computation, an inflated gross income figure based on the corporations' list prices rather than on the actual receipts produced by the so-called discount prices.

SUMMARY OF ARGUMENT

The taxpayer is an integrated miner-manufacturer of cement, as was its predecessor in interest, Arizona Portland. An integrated cement producer mines the principal ingredient of cement, calcium carbonate rock, and grinds it together with other mineral materials (additives) into a raw mix known as kiln feed. Under the applicable statutory provision, the preparation of the kiln feed terminates the mining phase of the producer's operations. Thereafter, the producer manufactures cement from the kiln feed and sells the finished cement in bulk and bags. All of the producer's costs in mining, manufacturing and marketing the cement were reflected in the prices charged customers.

The depletable mining income of an integrated producer of cement is its constructive income from the raw mineral product of mining (kiln feed) which he is deemed to sell to himself. Long-established Tressury Regulations prescribe the proportionate profits method of computing an integrated producer's constructive

mining income where, as here, there is no representative price in the industry for the product of mining. Under the proportionate profits method, the producer's gross income from sales of its manufactured product is allocated between mining and non-mining income in the ratio that mining costs bear to the total costs of producing the sales. Every dollar of income and every dollar of costs must go into the computation. To the extent that non-mining costs are treated as mining costs, or omitted from the computation, the net effect is to give the producer depletion on non-mining income.

In the instant case, the District Court erroneously allocated non-mining costs to mining costs (i.e., the expenses of handling and storing minerals other than calcium carbonate rock), and erroneously omitted from the computation altogether non-mining costs underlying the sales of finished cement (i.e., the costs of bags and bagging, and certain selling expenses). The court also erroneously distorted the gross income from sales of cement by omitting income from sales of bagged cement, and by treating list prices as the selling prices, whereas the co-called discount prices were the actual selling prices and were reflected in the actual gross sales.

ARGUMENT

I

THE DISTRICT COURT HAS ERRONEOUSLY INTERPRETED AND APPLIED THE PROPORTIONATE PROFITS METHOD AND THEREBY HAS ALLOWED DEPLETION ON NON-MINING INCOME

A. The proportionate profits method and its statutory context in this litigation

Section 611(a) of the Internal Revenue Code of 1954, Appendix A, infra, provides in pertinent part that in "the case of mines, * * * [and] other natural deposits, * * * there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion * * *, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate". 2/ Section 613(a), Appendix A, infra, provides that "the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property * * *." Section 613(c)(1), Appendix A, infra, defines "gross income from the property" in the case of a property other than an oil or gas well, as "gross income from mining", and Section 613(c)(2), Appendix A, infra, defines "mining".

2/ For the taxable years ended April 30, 1953, and April 30, 1954, the depletion allowance was authorized by Section 23(m) of the Internal Revenue Code of 1939. The provisions governing percentage depletion and defining "gross income from mining", now contained in Section 613 of the 1954 Code, were contained in Section 114 of the 1939 Code. Apart from changes in percentage rates, the relevant provisions in the two Codes are substantially similar, save as noted in the text. In the main, therefore, only the 1954 Code provisions will be cited and quoted, in the interest of simplicity.

As originally enacted, Section 613(c)(2) carried over the definition of "mining" in Section 114(b)(4)(B) of the 1939 Code, as including --

> not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products, and so much of the transportation of ores or minerals * * * from the point of extraction from the ground to the plants or mills in which the ordinary treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary or his delegate finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills.

In short, depletable income from "mining" was income from the "commercially marketable" product of "ordinary treatment processes normally applied by mine owners or operators * * *."

Section 613(c)(4), as originally enacted, set forth examples of "ordinary treatment processes" which were part of "mining". As to many minerals, however, including calcium carbonates, fire clay and shale, the statute provided no definite guidelines as to what constituted "ordinary treatment processes" and a "commercially marketable" product. Controversies over these terms were complicated in the case of integrated miner-manufacturers whose gross income was only from sales of their finished manufactured products.

Basic principles for determining the depletable "gross income from mining" of an integrated miner-manufacturer were finally supplied by the Supreme Court in United States v. Cannelton Sewer Pipe Co., 364 U.S. 76. There the taxpayer mined fire clay and shale and manufactured them into sewer pipe and other vitrified products. It claimed the depletion allowance on its gross sales of the manufactured products, contending that these products were the first "commercially marketable" result of "ordinary treatment processes" because it could not sell its raw minerals at a profit. Rejecting this contention, the Supreme Court held that (p. 86) "Congress intended to grant miners a depletion allowance based on the constuctive income from the raw mineral product if marketable in that form", and that raw minerals are "commercially marketable" under the statute when "ready for industrial use or consumption" -- whether or not a taxpayer can sell them at a profit.[3/]

3/ In Cannelton the Court noted that there were non-integrated miners of fire clay who sold the raw mineral product. However, it is settled that the Cannelton principles apply even to a completely integrated industry where there are no sales of the raw mineral. Riddell v. Monolith Cement Co., 371 U.S. 537; United States v. Longhorn Portland Cement Co., 328 F. 2d 491 (C.A. 5th); United States v. Light Aggregates, Inc., 343 F. 2d 429 (C.A. 8th).

The Court further held that (p. 89) "Congress intended integrated mining-manufacturing operations to be treated as if the operator were selling the mineral to himself for fabrication", and, more specifically, that an integrated taxpayer's constructive "gross income from mining" should be computed at the processing point where a non-integrated miner would be ready to ship and sell the minerals. Generally, the Court emphasized (p. 88) that depletion is an allowance "for exhaustion of minerals alone", and cannot be extended for the benefit of a miner-manufacturer to "a similar allowance on his manufacturing costs, including depreciation on his manufacturing plant, machinery and facilities."

Thereafter, Congress undertook to spell out more specifically what constituted mining processes and where they ended (the so-called mining cutoff point). Section 613 was amended in 1960 by Section 302(b) of the Public Debt and Tax Rate Extension Act of 1960, Appendix A, <u>infra</u>, to define "mining" in subsection (c)(2) as including not merely extraction but "also the treatment processes considered as mining described in paragraph (4) (and the treatment processes necessary or incidental thereto)" plus transportation defined as before. Section 613(c)(4), which had theretofore set forth examples of "ordinary treatment processes", was amended to provide in pertinent part:

> The following treatment processes where applied by the mine owner or operator shall be considered as mining to the extent they are

> applied to the ore or mineral in respect of which he is entitled to a deduction for depletion under section 611.
>
> * * * * *
>
> (F) in the case of calcium carbonates and other minerals when used in making cement--all processes (other than preheating of the kiln feed) applied prior to the introduction of the kiln feed into the kiln, but not including any subsequent process; * * *

The new definitions of mining processes were originally applicable only to taxable years beginning after December 31, 1960. (Section 302(c), Appendix A, <u>infra</u>.) Thereafter, however, by Section 4 of the Act of September 14, 1960, Appendix A, <u>infra</u>, the new definitions were made retroactive to earlier years at the election of taxpayers. In the instant case, taxpayer and Arizona Portland timely elected to compute their "gross income from mining" for all of the taxable years involved under the new Section 613(c)(4)(F). Hence their "mining' of minerals "in respect of which" they were entitled to depletion ended with the final preparation of the kiln feed.

The specific methods by which "gross income from mining" shall be computed are set forth in the long-standing provisions of Section 39.23(m)-1(e)(3) of Treasury Regulations 118 (1939 Code), Appendix A, <u>infra</u>, which are applicable to all taxable years beginning after December 31, 1951. 4/ These provisions deal first with the simple

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4/ Although Treasury Regulations 118 were promulgated under the 1939 Code, they are applicable under the 1954 Code until superseded by new Regulations. Section 7807 of the 1954 Code, Appendix A, <u>infra</u>. New Regulations have been proposed but have not yet been promulgated.

situation where a miner sells his crude mineral in the immediate vicinity of the mine, without processing it beyond the mining cutoff point. In that situation, the miner's "gross income from mining" is equivalent to its gross sales. If, however, the taxpayer applied non-mining processes before sale, or transports the crude mineral before sale beyond the immediate vicinity of the mine, then its "gross income from mining" is not its gross sales but --

> the representative market or field price (as of the date of sale) of a mineral product of like kind and grade as beneficiated by the ordinary treatment processes actually applied, before transportation of such product (other than by transportation treated, for the taxable year, as mining). 5/

Finally, Section 39.23(m)-1(e)(3) deals with situations where there is no representative market or field price for the product of mining, i.e., where there is a largely integrated industry in which the crude mineral is generally not traded and sold because almost every member of the industry mines his own minerals and uses them in manufacturing the end product. That is concededly the situation here with respect to the kiln feed. Under such

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5/ Section 39.23(m)-1(e)(3) equates mining processes with "ordinary treatment processes", in accordance with the statutory definition of mining in force when Treasury Regulations 118 were adopted. Now, of course, the provision must be read in terms of the treatment processes defined as mining in Section 613(c)(4).

circumstances, the regulation provides that the constructive "gross income from mining" of the miner-manufacturer shall be computed as follows:

> If there is no such representative market or field price (as of the date of sale), then there shall be used in lieu thereof the representative market or field price of the first marketable product resulting from any process or processes * * * minus the costs and proportionate profits attributable to the transportation (other than transportation treated, for the taxable year, as mining) and the processes beyond the ordinary treatment processes. * * *

This prescription (hereinafter "the proportionate profits method") is followed by the proviso that a method of computation other than a "computation of profits proportionate to costs" may be used if the taxpayer establishes to the satisfaction of the Commissioner that the proposed method clearly reflects the taxpayer's gross income from mining.

In United States v. Portland Cement Co. of Utah, 378 F. 2d 91 (C.A. 10th), the court said of the regulation and the proportionate profits method (p. 94):

> The decision in Douglas v. Commissioner of Internal Revenue, 322 U.S. 275, 281, points out that because Congress "obviously could not foresee the multifarious circumstances which would involve questions of depletion, it delegated to the Commissioner the duty of making the regulations." Here we are concerned with a regulation of more than 25 years standing. It has been before the courts a number of times without question

> of its underlying validity being raised. The taxpayer has the burden of showing both that the proportionate-profits method of the regulations is unreasonable and that its substitute-materials method is reasonable.

In the instant case, the District Court found that the proportionate profits method as prescribed by the regulation was applicable (No. 22,397, I-R. 124; No. 22,398, I-R. 184), and taxpayer did not disagree. Indeed, in its returns for the taxable years, taxpayer purported to use the proportionate profits method in computing its "gross income from mining", and since then has never claimed that it is entitled to use another method. (No. 22,397 and No. 22,398 Pltf. Ex. 20 A-D, pp. 325-326, 332-333.)[6/] However, as will appear, the rulings of the District Court are irreconcilable with the proportionate profits method and have allowed depletion on income which is clearly non-mining in character.

Before turning to the specific issues, it is important to consider with care the exact nature of the proportionate profits method and the basic principles which must govern its application.

In Whitehall Cement Manufacturing Co. v. United States, 369 F. 2d 468, 472 (C.A. 3d), the court aptly described the method as "cost oriented" and as requiring "an allocation of [the taxpayer's] total gross income between mining and non-mining operations in the

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6/ Plaintiffs' Exhibit 20 A-D is a four-volume compilation of depositions.

proportion which mining costs bear to the total costs of the cement sold". As set forth in Whitehall, the required allocation of gross income is reflected in the following mathematical formula:

$$\frac{\text{Mining costs}}{\text{Total (mining plus non-mining costs)}} \times \text{gross sales} = \text{gross income from mining}$$

The application of this formula does not turn upon accounting concepts; it is controlled by the tax concept of "gross income from mining", which, in the case of an integrated miner-manufacturer, means his constructive income from the raw mineral product of "mining". United States v. Portland Cement Co. of Utah, supra; United States v. Cannelton Sewer Pipe Co., supra.

As indicated in the Whitehall statement of the formula, the total income which is to be allocated between mining and non-mining is, as a practical matter, the taxpayer's total gross income from sales of its manufactured product. The regulation defines the amount to be allocated as "the representative market or field price of the first marketable product" -- which is the sales price actually charged and collected by the taxpayer, absent a showing to the contrary, for its manufactured end product (here, finished cement).

Two basic principles govern the allocation of gross sales between mining and non-mining income:

1. Every dollar of the costs that have produced the gross sales must go into the computation; and

2. Every dollar of such costs is treated as earning the same percentage of profits.

As the Court of Claims said in Standard Lime and Cement Co. v. United States, 329 F. 2d 939, 944, the method is centered on the "basic assumption * * * that each dollar of costs expended to produce and sell the end product earns the same percentage of the profit". (Emphasis supplied.) Accord, United States v. Portland Cement Co. of Utah, supra. This approach is the very heart of the cost-oriented proportionate profits method, and any departure produces a distorted result.

Thus, elimination of any item of cost from the computation distorts the allocation of the taxpayer's gross sales. Equally, the allocation is distorted if any costs other than those properly attributable to mining, as defined in the statute, are allocated to the numerator of the cost fraction (mining costs). Every dollar of the costs expended to produce and sell the manufactured product, other than mining costs, must be allocated to the denominator of the fraction (total, or mining plus non-mining costs). If costs other than those of mining are allocated to the numerator, or omitted from the denominator, the resulting allocation extends the depletion allowance to non-mining income, contrary to the statute.

The degree of difficulty in identifying costs as mining or non-mining varies with the type of cost. The costs of extraction

and the processes defined in the statute as mining are (to the extent the processes are applied to the minerals mined by the taxpayer) clearly mining costs. The costs of manufacturing processes are, of course, non-mining. As for other costs of producing and selling the manufactured end product, the Court of Claims held in Standard Lime and Cement Co., supra, that such costs are allocable to mining only to the extent that they are incurred for the benefit of the mining phase of the integrated producer's operations. The court emphasized that the Congressional intent underlying the depletion provisions requires a clear showing of benefit to mining and to the raw mineral product of mining (kiln feed, there as here). It said in part (329 F. 2d, p. 946):

> We believe that Congress intended to include in gross income from mining only those cost items (and a percentage of the entire profit attributable to them) which were incurred for the benefit of the mining operations as defined in section 613(c)(4). This result is inescapable since we must view depletion as "an allowance for the exhaustion of a capital asset." United States v. Cannelton Sewer Pipe Co., supra, at 86, * * * This capital asset under the statutory definition is measured for depletion purposes in terms of "gross income from mining." It follows that only those costs incurred for the benefit of the mining operation as particularized by the statutory scheme, can be included. The language of subparagraph (F) of subsection 613(c)(4) demands this conclusion, for it specifically includes all processes up to kiln feed "but not including any subsequent processes." [Emphasis in original.] We interpret this as excluding any subsequent manufacturing

> or marketing processes. Admittedly, our holding might be contrary to accepted cost accounting principles, but the purpose of depletion allowance is not to recompense for the cost of manufacturing and marketing of the end product but is to allow for the exhaustion of the mineral assets. Thus the depletion rate must be applied as nearly as possible to the income derived from the mining of the raw materials as defined in the statutory scheme. [Emphasis supplied.]

We submit that the Court of Claims' approach is sound, and hence that no part of an integrated producer's costs (other than direct mining process costs) may be allocated to mining unless there is a discernible, demonstrable benefit to mining and the crude mineral product thereof. As will appear, the Third Circuit has taken the same approach in Whitehall in deciding issues which included some of the very questions presented here.

II

THE DISTRICT COURT ERRED IN ALLOCATING TO MINING COSTS THE EXPENSES OF SEPARATELY HANDLING AND STORING MINERAL MATERIALS (ADDITIVES) OTHER THAN CALCIUM CARBONATE ROCK

While calcium carbonate rock is the principal ingredient of cement, it was necessary for taxpayer and Arizona Portland to add certain mineral materials in the raw grinding stage to produce the proper blend in the kiln feed. These additives (iron ore and quartzite) were stored separately prior to the raw grinding stage. The corporations purchased the additives save in the case of the

iron ore used by taxpayer, which taxpayer mined from its own deposits. The question is whether the costs of separately storing and handling the additives, prior to raw grinding, were allocable to mining costs in the proportionate profits computation. It is stipulated that these costs (kept separately on taxpayer's books) do not include the costs of the physical addition of the additives to the calcium carbonate rock. (Pltf. Ex. 20 A-D, p. 214.) Hence the costs of physical addition are not involved here.

The District Court ruled that the costs of handling and storing the additives were costs of mining "treatment processes" applied by the corporations to their calcium carbonate rock, under the statute. (No. 22,397, I-R. 128; No. 22,398, I-R. 189.) Hence it ruled that such costs were allocable to mining costs in the proportionate profits computation. (No. 22,397, I-R. 123; No. 22,398, I-R. 182-183.) We submit that these rulings were erroneous.

Section 613(c)(4), in the amended form applicable to the taxable years involved, provides in its preamble that the "treatment processes" enumerated therein "shall be considered as mining to the extent they are applied [by the mine owner or operator] to the ore or mineral in respect of which he is entitled to a deduction for depletion under section 611 * * *". This litigation involves the computation of depletable mining income from calcium carbonate rock used in the production of finished cement. Hence only "treatment

processes" applied to calcium carbonate rock are "mining" processes within the purview of the statute. It should be obvious that the separate handling and storage of mineral materials other than calcium carbonate rock are not "treatment processes" applied to the ore or mineral "in respect of which" the taxpayer and Arizona Portland are entitled to a deduction for depletion.

This Court has already dealt with the governing criteria in Riddell v. California Portland Cement Co., 330 F. 2d 16. There the instant taxpayer contended that its costs of purchasing the quartzite and mining the iron ore were costs of "treatment processes * * * considered as mining" with respect to its calcium carbonate rock. This Court rejected the contention. As for the iron ore mined by taxpayer, the Court noted that taxpayer had already been allowed depletion on such ore; that separate depletion of the mineral components of the kiln feed was required by law; and that allowing the taxpayer to include the costs of mining the iron ore in its costs of mining calcium carbonate rock would give the taxpayer double depletion on the iron ore. As for the quartzite, the Court said (p. 18):

> If inclusion of iron ore extracted by taxpayer is improper, a fortiori inclusion of quartzite purchased from someone else is improper. Taxpayer has no "economic interest" in the quartzite.

The Court quoted from the legislative history of the 1960 amendments to Section 613(c)(2)(4), i.e, H. Conference Rep. No. 2005,

86th Cong., 2d Sess., pp. 8-9 (1960-2 Cum. Bull. 741, 746), Appendix A, infra, this significant passage:

> As under existing law, a described process is to be treated as mining where performed by another person for the mineowner or operator if the mineowner or operator has not disposed of his depletable interest in the ore or mineral to which such process is applied. Under the language of this provision, a described process is not treated as mining where applied to a purchased ore or mineral.

Emphasizing the limitation in the preamble to Section 613(c)(4), the Court concluded (pp. 18-19):

> The depletion allowance sought here is in respect of limestone. Under the Cannelton doctrine, "mining" ceases at the crushing stage. * * * The Congress granted relief from this rule by including treatment processes applied to the mineral up to the kiln-feed stage. Surely Congress did not mean to grant the additional relief of allowing depletion upon minerals already depleted or in which the taxpayer had but an "economic advantage."

Without more, we submit that the costs of the separate handling and storage of the mineral additives were not costs of "treatment processes" which constituted "mining" with respect to the calcium carbonate rock used in producing cement. They were non-mining costs and as such should have been allocated to the denominator of the cost fraction, rather than the numerator, in the proportionate profits computation.

III

THE DISTRICT COURT ERRONEOUSLY EXCLUDED CERTAIN POST-MANUFACTURING COSTS AND INCOME FROM THE COMPUTATION

The errors of the District Court in excluding certain post-manufacturing costs and income from the computation have a common root: the court simply did not apply the proportionate profits method. Instead, it based its ruling on a statutory definition of the mining cutoff point -- a definition irrelevant to the issues. This basic confusion is clear from the orders for preparation of findings, conclusions and judgment. (No. 22,397, I-R. 117-118; No. 22,398, I-R. 170-171.)

In those orders, the court invoked, as controlling, the pre-1960 definition of "mining" as including "ordinary treatment processes" applied "in order to obtain" mineral products in "commercially marketable" form. (Section 613(c)(2) of the 1954 Code, as originally enacted, Appendix A, <u>infra</u>, which carried over the definition in Section 114(b)(4)(B) of the 1939 Code, as amended.) The court ruled that this definition required the exclusion of various costs from the proportionate profits computation, including selling expenses and the costs of bags and bagging, because they were incurred "<u>after</u> the products were <u>obtained</u> in 'commercially marketable' form". In support of this ruling, the court cited the Supreme Court's decisions in <u>Cannelton</u> and <u>Monolith</u>. The court held

that the first "commercially marketable" product of the corporations' cement-producing operations was bulk cement only, notwithstanding the fact that the finished cement was sold both in bulk and in bags; and, in addition to excluding selling expenses and costs of bags and bagging, it excluded income from the sales of bagged cement from the computation. (No. 22,397, I-R. 124-125; No. 22,398, I-R. 184-185.)

The court's reliance was misplaced. The pre-1960 statutory definition of "mining" and the Cannelton and Monolith decisions had nothing whatever to do with how an integrated producer's constructive income from mining should be computed. Cannelton and Monolith made it clear that an integrated producer is entitled to depletion only on his constructive income from the raw mineral product of "mining". And these decisions defined the mining cutoff point as being reached when the raw mineral product of "mining" is ready for industrial use or consumption -- that is, when a non-integrated miner would be ready to ship and sell his product. The Supreme Court treated the integrated producer as selling his raw mineral to himself at the mining cutoff point.

While Cannelton and Monolith dealt with the pre-1960 statutory definition of "mining", they are equally applicable to the mining cutoff point for calcium carbonate rock prescribed by Section 613(c)(4)(F), Appendix A, infra, as added in 1960 and applicable to

the taxable years here involved. Thus the integrated cement producer's depletable mining income, under Section 613(c)(4)(F), is his constructive income from kiln feed when it is ready for industrial use and consumption; at that point, he is deemed to sell it to himself for manufacture.

But the statute and the cited decisions provide only the context and points of reference for the computation; they do not provide the least intimation as to how the computation is to be made. For more than 25 years, the method of computation for integrated industries prescribed by regulation has been the proportionate profits method. That method is wholly consonant with the statute and with Cannelton and Monolith. Under the statute, the depletion allowance is a percentage of income. Cannelton and Monolith limit an integrated producer to depletion on his constructive income from constructive sales of the mining product to himself. Under the proportionate profits method, logically, this constructive income is derived from actual figures: the integrated producer's actual gross income from sales of its manufactured products and its actual costs of producing and selling those products.

The District Court was mistaken on another score. The pre-1960 statutory definition of "mining" did not deal with processes which produced a "commercially marketable" manufactured product -- only with processes which produced a raw mineral ready for industrial

use and consumption. The District Court, however, misconstrued "ordinary treatment processes" as including manufacturing processes, and then concluded that finished bulk cement was the first "commercially marketable" product -- under a definition of "mining". This is confusion worse confounded.

As prescribed in the regulation, the proportionate profits method also refers, of course, to processes and marketability. But the total cost and income figures to be allocated are not measured by reference to mining and manufacturing processes only, or to some abstract valuation of the manufactured product, independent of sales. The income figure to be allocated between mining and non-mining, under the method, is "the representative market or field price of the first marketable product resulting from any process or processes". [Emphasis supplied.] In practice, as noted, the "price" thus allocated is usually the integrated producer's actual gross sales. And an undistorted allocation of the gross sales is achieved only by including, in the cost fraction, every dollar of costs which produced sales. This is precisely what the regulation requires. It is plainly framed in terms of all the costs underlying the price at which the manufactured product is sold, and provides for an allocation of that price to non-mining in proportion to the costs of all "processes beyond the ordinary treatment [mining] processes" -- not just manufacturing processes. [Emphasis supplied.]

As the Court of Claims said in Standard Lime and Cement Co. v. United States, supra, p. 944, "each dollar of costs expended to produce and sell the end product" must be taken into account as earning the same percentage of the profit.

Neither in logic nor on any other ground is there warrant for any other construction of the method's treatment of post-mining costs, i.e., the costs of "processes" beyond mining processes. Among a variety of definitions, Webster defines a "process" broadly as: "A series of actions or operations definitely conducing to an end". This definition is more than ample to cover all of taxpayer's post-manufacturing "actions or operations definitely conducing" to the sales of its manufactured product. In Standard Lime the court referred (329 F. 2d, p. 946) to both manufacturing and marketing as post-mining processes. The reference in Section 613(c)(4)(F) to post-mining processes ("any subsequent process") must be read as broadly embracing both manufacturing and marketing activities, if it is to accord with the statutory requirements for depletion.

In the Senate debates on the so-called Gore amendment, Section 302(b) of the Public Debt and Tax Rate Extension Act of 1960, Appendix A, infra, which added the new definitions of mining to Section 613(c)(4), Senatore Gore stated (106 Cong. Record, Part 10, p. 13240):

> To state the question briefly, the proposed amendment changes the definition of "mining" to preclude the interpretation of the term as including operations involved in processing the finished product, the packaging and shipping of the finished product.

All of such non-mining costs of marketing operations must be included in the denominator of the cost fraction, in the proportionate profits computation, in order to secure a proper allocation of gross sales to mining and non-mining income.

A. <u>The District Court erred in excluding the income from sales of bagged cement, and the costs of bags and bagging, from the computation</u>

For the reasons given above, the District Court erred in excluding the costs of bags and bagging from the computation. By the same token, the court erred in excluding the income from sales of bagged cement. The first "marketable product" was finished cement; the finished cement was sold both in bulk and in bags. Bagging was simply a marketing process producing a portion of its actual gross sales.

The District Court's rulings in this respect are in direct conflict with the decision of the Third Circuit in <u>Whitehall Cement Manufacturing Co</u>. v. <u>United States</u>, 369 F. 2d 468. There the taxpayer sold bagged cement for a price which included a premium referable to its additional packaging costs. The premium was less than the packaging costs. The taxpayer contended that it sustained a loss in the amount of the difference between the two, and that

both the income and the costs of this loss operation should be excluded from the proportionate profits computation. The Third Circuit noted that the taxpayer realized a net profit from sales of bagged cement, albeit less than the profit which would have been realized from the sale of the same cement in bulk; and it held that the exclusions urged by the taxpayer would distort the allocation fraction. The court said (p. 474):

> There is implicit in the plaintiff's argument an erroneous assumption that the packaging costs produced only the additional revenue derived from the premiums, and this was less than the costs. The sale of cement in bags was presumably an accommodation to those customers whose particular requirements were such as to make the purchase of cement in bulk commercially unfeasible. The availability of packaged cement was undoubtedly a sales inducement to such customers. It seems reasonable to infer that the profits realized from the sale of packaged cement * * * were attributable at least in part to the packaging costs. We are of the opinion that packaging costs were properly allocable to the non-mining operations. * * * The profits attributable to such costs were similarly allocable.

In the instant case, as in Whitehall, the premium for bagged cement did not cover the packaging costs and the sales of bagged cement were therefore not as profitable as sales of cement in bulk. Nevertheless, as in Whitehall, the sales of bagged cement did produce an over-all profit.(Pltf. Ex. 20 A-D, p. 470.) Such sales met the particular needs of a group of customers and undoubtedly were a sales inducement to purchases by such customers. The proceeds of

such sales were part of the corporations' gross sales, and the costs of bags and bagging were part of the corporations' expenses of marketing their finished cement. To exclude the bag premium from gross sales and the non-mining costs of bags and bagging from the denominator of the cost fraction, in the proportionate profits computation, "would result in a modification of the allocation fraction and consequently an increase of the depletion base". Whitehall Cement Manufacturing Co. v. United States, supra, p. 474.

B. The District Court erred in excluding selling expenses from the computation; they should be included as non-mining expenses in their entirety

During the taxable years, taxpayer and Arizona Portland incurred certain selling expenses with respect to finished cement, consisting primarily of salaries and other expenses of salesmen and membership in various industry trade associations. The District Court ruled that these expenses should be excluded from the computation or, alternatively, allocated between mining and non-mining costs because they benefitted the mining product. (No. 22,397, I-R. 125; No. 22,398, I-R. 185.) We submit that exclusion was error, and that allocation would be equally erroneous.

The expenses involved were part of the costs which produced the gross sales to be allocated between mining and non-mining income and, as such were includible in the proportionate profits

computation. Moreover, they were non-mining costs in their entirety. They were incurred solely to generate sales of the manufactured end product, finished cement. Integrated producers are their own market for their kiln feed, and are deemed under Cannelton to sell it to themselves. But they incur no actual selling expenses in this connection, and there is nothing in the record to show that sales of the finished cement are promoted by reference to some special quality in a producer's kiln feed. Nor is there anything in the record which would indicate, as a basis for allocation, what the selling expenses of an unintegrated kiln feed producer might be.

Taxpayer had a sales department with a staff of 10 to 15 outside salesmen who operated generally throughout the southern California and southern Arizona territory. (Pltf. Ex. 20 A-D, p. 179.) There is no way in logic whereby the salaries and expenses of these salesmen could be referred back to "sales"of kiln feed. By contrast, some general administrative overhead costs are properly allocable between mining and non-mining because they demonstrably benefit both phases of an integrated operation. Thus, where an executive has responsibilities and duties with respect to both phases, his salary may be allocable. No such basis exists for allocating expenses of selling the finished cement.

Indeed, it should be noted that a manufacturer of cement

who buys his kiln feed (such as Blue Diamond in the instant litigation) would incur exactly the same selling expenses as an integrated producer, and would be at a distinct competitive disadvantage if the integrated producer were allowed to inflate its depletion base by allocating a portion of such expenses to mining costs.

In an intangible sense, it may be said that all of an integrated producer's costs indirectly benefit its entire operation. But the Government does not suggest that, for that reason, a portion of recognized mining costs should be allocated to non-mining; no more should the integrated producer be heard to say that costs of marketing the manufactured product should be allocated to mining costs -- certainly not in the absence of a showing of a rational and logical basis for allocation. In the instant case, as in United States Pipe & Foundry Co. v. Patterson, 203 F. Supp. 335, 364 (N.D. Ala.), the taxpayer cannot point to any item of selling expense that is "properly or fairly allocable" to mining.

As the Court of Claims said in Standard Lime and Cement Co. v. United States, supra, p. 946:

> It follows that only those costs incurred for the benefit of the mining operation as particularized by the statutory scheme, can be included. The language of subparagraph (F) of subsection 613(c)(4) demands this conclusion, for it specifically includes all processes up to kiln feed "but not including any subsequent

> processes." We interpret this as excluding any subsequent manufacturing or marketing processes. [Emphasis supplied.]

IV

THE DISTRICT COURT ERRED IN ALLOCATING BETWEEN MINING AND NON-MINING INCOME AN INFLATED GROSS INCOME FIGURE BASED ON LIST PRICES RATHER THAN ON THE ACTUAL RECEIPTS PRODUCED BY THE SO-CALLED DISCOUNT PRICES

The District Court ruled that discounts to customers were offered exclusively for the purpose of inducing prompt payment, not for the purpose of inducing sales, and should not be deducted in determining depletable gross income from mining. (No. 22,397, I-R. 123, 128; No. 22,398, I-R. 182, 189.) In other words, the court ruled that the income figure in the proportionate profits computation should be based on list prices. The Government contends that this ruling is erroneous; that the actual selling prices, producing the actual gross sales receipts, were the so-called discount prices; and that depletable mining income must be derived, under the proportionate profits method, from the "representative * * * price" reflected in the actual receipts.

It is stipulated that, during the taxable years, all of the major cement producers in the Los Angeles marketing area -- including taxpayer -- offered precisely the same discount on precisely the same terms: 20 cents per barrel for payment by the 10th of the month following the invoice date or within 30 days. (No. 22,397, I-R. 113; No. 22,398, I-R. 165.) Mr. Donoghue, the president of

Blue Diamond Company, a large purchaser of finished cement from the taxpayer and other companies, testified (Pltf. Ex. 20 A-D, pp. 137-138):

> Q. You had no doubt that you could get that barrel discount, did you?
>
> A. I believe it was a standard discount for cement companies, at least in the State of California.
>
> Q. Then it had no influence upon your purchasing decisions, did it?
>
> A. From whom we purchased?
>
> Q. Yes, sir.
>
> * * * * *
>
> A. It would be a question of competitive price. It would affect the selling price if there were a cement company that did not offer the 20-cent-a-barrel discount.

Significantly, only a small percentage of the discounts were ever disallowed. For example, during its taxable year ended April 30, 1959, taxpayer allowed discounts totaling $453,072 from the Colton cement plant and $775,565 from the Mojave cement plant, whereas only $347.85 in potential discounts were disallowed. (No. 22,398, I-R. 103, 112.)

The discount was offered on all sales of cement to all customers irrespective of their credit standing. (Pltf. Ex. 20 A-D, p. 223.) By contrast, the small discounts for prompt payment

allowed from taxpayer's Colton lime plant were highly selective and given only on flour-sized ground rock. (Pltf. Ex. 20 A-D, pp. 229-230.)

Whatever the original reasons for the discount, it is abundantly evident from the foregoing stipulated and evidentiary facts that the so-called discount prices were the actual selling prices, set in competition within the industry. The reduction from list prices was a competitive pricing device with too substantial an impact upon the taxpayer's actual receipts to be regarded as anything but a trade discount. The disallowance of the discount to a few delinquent customers, in negligible amounts, does not derogate from that conclusion.

Dr. Taylor, an independent account expert, testified as follows (Pltf. Ex. 20 A-D, pp. 109-110, 112):

> Q. How would you characterize the difference between a trade discount and a cash discount in a normal accounting sense?
>
> A. A trade discount is part of the bargaining of the price to consummate the transaction, and the cash discount, in its essence is given for the purpose of encouraging payment. * * *
>
> *   *   *   *   *
>
> Q. * * * Were the discounts actually allowed a high percentage of sales, in your opinion?
>
> A. Yes.
>
> Q. In the light of the facts and the accounting concepts, how would you characterize the discounts allowed in this case?

> A. I think that the plaintiff (and consistent with the total cement industry) has a discount as a price-making device, and it therefore partakes more of the nature of a trade discount than a discount which would be related as a financial function.

We submit, in sum, that the true selling price -- the "representative * * * price", in the language of the regulation -- was the so-called discount price. And the actual gross income received from sales of cement at this price is the income to be allocated between mining and non-mining, under the proportionate profits method.

CONCLUSION

For the reasons stated above, the judgments of the District Court should be reversed.

Respectfully submitted,

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MARCH, 1968.

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19, and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: 14th day of March, 1968.

Loyal E. Keir

Assistant United States Attorney.

APPENDIX A

Internal Revenue Code of 1954:

SEC. 611.[7] ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) General Rule.--In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. * * *

*　　*　　*　　*　　*

(26 U.S.C. 1964 ed., Sec. 611.)

SEC. 613.[8] PERCENTAGE DEPLETION.

(a) General Rule.--In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property * * *. * * *

7/ Section 23(m) of the Internal Revenue Code of 1939 (26 U.S.C. 1952 ed., Sec. 23), applicable for the taxable years ending April 30, 1953, and 1954, is substantially the same as Section 611(a) of the Internal Revenue Code of 1954.

8/ Section 114(b)(3) and (4) of the Internal Revenue Code of 1939, as amended by Section 145, Revenue Act of 1942, c. 619, 56 Stat. 798; Section 124, Revenue Act of 1943, c. 63, 58 Stat. 21; Section 207, Revenue Act of 1950, c. 994, 64 Stat. 906; and Section 319, Revenue Act of 1951, c. 521, 65 Stat. 452 (26 U.S.C. 1952 ed., Sec. 114), applicable for the taxable years ending April 30, 1953, and 1954, is substantially the same as Section 613 of the Internal Revenue Code of 1954.

(b) Percentage Depletion Rates.--The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

*　　*　　*　　*　　*

(6) 15 percent--all other minerals (including but not limited to * * * limestone * * *), except that * * *

*　　*　　*　　*　　*

(c) Definition of Gross Income from Property.--For purposes of this section--

(1) Gross income from the property.--The term "gross income from the property" means, in the case of a property other than an oil or gas well, the gross income from mining.

(2) Mining.--The term "mining" includes not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products, and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which the ordinary treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary or his delegate finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills.

*　　*　　*　　*　　*

(4) Ordinary treatment processes.--The term "ordinary treatment processes" includes the following:

*　　*　　*　　*　　*

(26 U.S.C. 1964 ed., Sec. 613.)

SEC. 7807. RULES IN EFFECT UPON ENACTMENT OF THIS TITLE.

(a) Interim Provision for Administration of Title.--Until regulations are promulgated under any provision of this title which depends for its application upon the promulgation of regulations (or which is to be applied in such manner as may be prescribed by regulations) all instructions, rules or regulations which are in effect immediately prior to the enactment of this title shall, to the extent such instructions, rules, or regulations could be prescribed as regulations under authority of such provision, be applied as if promulgated as regulations under such provision.

* * * * *

(26 U.S.C. 1964 ed., Sec. 7807.)

Public Debt and Tax Rate Extension Act of 1960, P.L. 86-564, 74 Stat. 290:

SEC. 302. DEPLETION RATE FOR CERTAIN CLAYS; TREATMENT PROCESSES CONSIDERED AS MINING FOR COMPUTING PERCENTAGE DEPLETION IN THE CASE OF MINERALS AND ORES.

* * * * *

(b) Treatment Processes Considered as Mining.--Subsection (c) of section 613 of the Internal Revenue Code of 1954 (relating to the definition of gross income from property) is amended as follows:

(1) by amending paragraph (2) to read as follows:

"(2) Mining.--The term "mining" includes not merely the extraction of the ores or minerals from the ground but also the treatment processes considered as mining described in paragraph (4) (and the treatment processes necessary or incidental thereto), and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which such treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary or his delegate finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills."

(2) By striking out paragraph (4) and inserting in lieu thereof the following new paragraphs:

"(4) Treatment processes considered as mining.--The following treatment processes where applied by the mine owner or operator shall be considered as mining to the extent they are applied to the ore or mineral in respect of which he is entitled to a deduction for depletion under section 611:

"(A) In the case of coal--cleaning, breaking, sizing, dust allaying, treating to prevent freezing, and loading for shipment;

"(B) in the case of sulfur recovered by the Frasch process--cleaning, pumping to vats, cooling, breaking, and loading for shipment;

"(C) in the case of iron ore, bauxite, ball and sagger clay, rock asphalt, and ores or minerals which are customarily sold in the form of a crude mineral product--sorting, concentrating, sintering, and substantially equivalent processes to bring to shipping grade and form, and loading for shipment;

"(D) in the case of lead, zinc, copper, gold, silver, uranium, or fluorspar ores, potash, and ores or minerals which are not customarily sold in the form of the crude mineral product--crushing, grinding, and beneficiation by concentration (gravity, flotation, amalgamation, electrostatic, or magnetic), cyanidation, leaching, crystallization, precipitation (but not including electrolytic deposition, roasting, thermal or electric smelting, or refining), or by substantially equivalent processes or combination of processes used in the separation or extraction of the product or products from the ore or the mineral or minerals from other material from the mine or other natural deposit;

"(E) the pulverization of talc, the burning of magnesite, the sintering and nodulizing of phosphate rock, and the furnacing of quicksilver ores;

"(F) in the case of calcium carbonates and other minerals when used in making cement--all processes (other than preheating of the kiln feed) applied prior to the introduction of the kiln feed into the kiln, but not including any subsequent process;

"(G) in the case of clay to which paragraph (5) (B) of subsection (b) applies--crushing, grinding, and separating the mineral from waste, but not including any subsequent process; and

"(H) any other treatment process provided for by regulations prescribed by the Secretary or his delegate which, with respect to the particular ore or mineral, is not inconsistent with the preceding provisions of this paragraph.

"(5) Treatment Processes Not Considered as Mining.--Unless such processes are otherwise provided for in paragraph (4) (or are necessary or incidental to processes so provided for), the following treatment processes shall not be considered as 'mining': electrolytic deposition, roasting, calcining, thermal or electric smelting, refining, polishing, fine pulverization, blending with other materials, treatment effecting a chemical change, thermal action, and molding or shaping.

(c) Effective Date.--The amendments made by subsections (a) and (b) shall be applicable only with respect to taxable years beginning after December 31, 1960.

Act of September 14, 1960, P.L. 86-781, 74 Stat. 1017:

SEC. 4. Subsection (c) of section 302 of the Public Debt and Tax Rate Extension Act of 1960 (Public Law 84-564; 74 Stat. 293) is amended to read as follows:

"(c) Effective Date.--

"(1) In general.--Except as provided in paragraph (2), the amendments made by subsections (a) and (b) shall be applicable only with respect to taxable years beginning after December 31, 1960.

(2) Calcium carbonates, etc.--

(A) Election for past years.--In the case of calcium carbonates or other minerals when used in making cement, if an election is made by the taxpayer under subparagraph (C)--

"(i) the amendments made by subsection (b) shall apply to taxable years with respect to which such election is effective, and

"(ii) provisions having the same effect as the amendments made by subsection (b) shall be deemed to be included in the Internal Revenue Code of 1939 and shall apply to taxable years with respect to which such election is effective in lieu of the corresponding provisions of such Code.

"(B) Years to which applicable.--An election made under subparagraph (C) to have the provisions of this paragraph apply shall be effective for all taxable years beginning before January 1, 1961, in respect of which--

"(i) the assessment of a deficiency,
"(ii) the refund or credit of an overpayment, or
"(iii) the commencement of a suit for recovery of a refund under Section 7405 of the Internal Revenue Code of 1954,

is not prevented on the date of the enactment of this paragraph by the operation of any law or rule of law. Such election shall also be effective for any taxable year beginning before January 1, 1961, in respect of which an assessment of a deficiency has been made but not collected on or before the date of the enactment of this paragraph.

(C) Time and manner of election.--An election to have the provisions of this paragraph apply shall be made by the taxpayer on or before the 60th day after the date of publication in the Federal Register of final regulations issued under authority of subparagraph (F), and shall be made in such form and manner as the Secretary of the Treasury or his delegate shall prescribe by regulations. Such election, if made, may not be revoked.

"(D) Statutes of limitation.--Notwithstanding any other law, the period within which an assessment of a deficiency attributable to the application of the amendments made by subsection (b) may be made with respect to any taxable year to which such amendments apply under an election made under subparagraph (C) and the period within which a claim for refund

or credit of an overpayment attributable to the application of such amendments may be made with respect to any such taxable year, shall not expire prior to one year after the last day for making an election under subparagraph (C). An election by a taxpayer under subparagraph (C) shall be considered as a consent to the application of the provisions of this subparagraph.

"(E) Terms; applicability of other laws.--Except where otherwise distinctly expressed or manifestly intended, terms used in this paragraph shall have the same meaning as when used in the Internal Revenue Code of 1954 (or corresponding provisions of the Internal Revenue Code of 1939) and all provisions of law shall apply with respect to this paragraph as if this paragraph were a part of such Code (or corresponding provisions of the Internal Revenue Code of 1939).

"(F) Regulations.--The Secretary of the Treasury or his delegate shall prescribe such regulations as may be necessary to carry out the provisions of this paragraph."

Treasury Regulations on Income Tax (1954 Code):

Sec. 1.9003-2
Effect of election.

(a) In general. If a taxpayer makes the election described in paragraph (b) of Section 1.9003-1, he shall be deemed to have consented to the application of section 302(b) of the Act with respect to all taxable years to which the election applies. Thus, subparagraph (F) of section 613(c)(4) of the Internal Revenue Code of 1954 as amended must be applied in determining gross income from mining for the taxable years to which the election applies (including years subject to the Internal Revenue Code of 1939) whether or not the taxpayer is litigating the issue. Further, the election shall apply to all calcium carbonates or other minerals mined and used by the taxpayer in making cement.

(b) Effect on gross income from mining. The election is only determinative of what constitutes "mining" for the purposes of computing percentage depletion and has no effect on

the method employed in determining the amount of gross income from mining. In applying the election to the years affected there shall be taken into account the effect that any adjustments resulting from the election shall have on other items affected thereby, such as charitable contributions, foreign tax credit, net operating loss, and the effect that adjustments to any such items shall have on other taxable years. The provisions of section 302(b) of the Act are applicable with respect to taxable years subject to the Internal Revenue Code of 1939 for purposes of applying section 450 and 453 of that Code.

(26 C.F.R. Sec. 1.9003-2.)

Treasury Regulations 118 (1939 Code):

Sec. 39.23(m)-1. Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.

*   *   *   *   *

(e) As used in section 114(b)(3) and 114(b)(4)(A) and section 39.23(m)-1 to 39.23(m)-19, inclusive, the term "gross income from the property" means the following:

*   *   *   *   *

(3) If the taxpayer sells the crude mineral product of the property in the immediate vicinity of the mine, "gross income from the property" means the amount for which such product was sold, but, if the product is transported or processed (other than by the ordinary treatment processes described below) before sale, "gross income from the property" means the representative market or field price (as of the date of sale) of a mineral product of like kind and grade as beneficiated by the ordinary treatment processes actually applied, before transportation of such product (other than transportation treated, for the taxable year, as mining).

If there is no such representative market or field price (as of the date of sale), then there shall be used in lieu thereof the representative market or field price of the first marketable product resulting from any process or processes (or, if the product in its crude mineral state is merely transported the price for which sold) minus the costs and proportionate profits attributable to the transportation (other than transportation treated, for the taxable year, as mining) and the processes beyond the ordinary treatment processes. If the taxpayer establishes to the satisfaction of the Commissioner that another method of computation, other than the computation of profits proportionate to costs, clearly reflects the gross income from the property, then such gross income shall be computed by the use of such other method.

*   *   *   *   *

H. Conference Rep. No. 2005, 86th Cong., 2d Sess., pp. 8-11 (1960-2 Cum. Bull. 741, 746-747):

<u>Treatment processes considered as mining</u>

*   *   *   *   *

Paragraph (2) of section 302(b) added to the bill under the conference agreement strikes out paragraph (4) of section 613(c) of the 1954 Code and inserts in lieu thereof new paragraphs (4) and (5).

<u>Specifically included treatment processes</u>.-- The new paragraph (4) of section 613(c) describes (in subpars. (A) to (H), inclusive) treatment processes which are to be considered as mining, where applied by the mineowner or operator, to the extent such processes are applied to the ore or mineral in respect of which the mine owner or operator is entitled to a deduction for depletion under section 611 of the 1954 Code. As under existing law, a described process is to be treated as mining where performed by another person for the mineowner or operator if the mineowner or operator has not disposed of his depletable interest in the ore or mineral to which such process is applied. Under the language of this provision, a described process is not treated as mining where applied to a purchased ore or mineral.

*   *   *   *   *

For calcium carbonates and other minerals when used in making cement, a new subparagraph (F) has been added providing for the allowance of all processing up to the point of the introduction of the kiln feed into the kiln (except for preheating of the kiln feed), but not including any subsequent process. * * *

Specifically excluded treatment processes.--The new paragraph (5) added to section 613(c) of the 1954 Code under the conference agrement provides that unless such processes are otherwise provided for in paragraph (4) (or are necessary or incidental to processes so provided for), the following treatment processes shall not be considered as "mining": electrolytic deposition, roasting, calcining, thermal or electric smelting, refining, polishing, fine pulverization, blending with other materials, treatment effecting a chemical change, thermal action, and molding or shaping.

* * * * *

H. Conference Rep. No. 2213, 86th Cong., 2d Sess., p. 4 (1960-2 Cum. Bull. 902, 904):

ELECTION AS TO BASE FOR DETERMINATION PERCENTAGE DEPLETION DEDUCTION IN THE CASE OF MINERALS USED IN MAKING CEMENT

Amendment No. 1: To determine the percentage depletion allowance under present law, it is necessary to multiply the percentage rate applicable to the particular mineral by the value of the mineral at the point at which the mining process ends. This point is referred to as the "cutoff point." In the case of many mineral industries, this cutoff point has been the subject of uncertainty and litigation. Included in this group is the cement industry.

In order to resolve the cutoff question for 1961 and future years, Congress in the Public Debt and Tax Rate Extension Act of 1960 modified section 613(c) of the Internal Revenue Code of 1954. As amended, this statutory provision established specific cutoff points for numerous minerals, including those used in the manufacture of cement. This cutoff point for cement-producing minerals (except for preheating of the kiln feed) occurs just prior to the introduction of the kiln feed into the kiln. This cutoff point is derived from a ruling published by the Treasury Department in 1953.

Although the recent legislation determines the cutoff point for the cement industry for future years, it does not settle this question for any open years prior to 1961. Senate amendment No. 1 permits taxpayers mining minerals used in making cement to elect to apply, for the years prior to 1961, the cutoff provisions adopted in the Public Debt and Tax Rate Extension Act of 1960. If a taxpayer fails to make the election, the cutoff point in his case for these years would be determined under existing law.

Under the amendment, if the taxpayer makes the election, it will apply to all of his mineral properties used in making cement and, in general, to all of his taxable years beginning before 1961 which are open on the date of the enactment of the bill. However, the making of the election resolves only the point at which the cutoff occurs and does not deal with any other matters which may be in issue, such as the method of computing the gross income at that point. The election must be made by the taxpayer on or before the date which is 60 days after the date of the publication of final regulations on this provision. Once made, the election is irrevocable.

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APPENDIX B

TABLE OF EXHIBITS PURSUANT TO RULE 18(2)(5) AS AMENDED:

Exhibit	Identified 9/	Offered	Received
Pltf. Ex. 1	II-R. 66	II-R. 73	II-R. 73
Pltf. Ex. 4	II-R. 67	II-R. 73	II-R. 73
Pltf. Ex. 5	II-R. 68	II-R. 73	II-R. 73
Pltf. Ex. 6	II-R. 68	II-R. 73	II-R. 73
Pltf. Ex. 7	II-R. 68	II-R. 73	II-R. 73
Pltf. Ex. 8	II-R. 69	II-R. 73	II-R. 73
Pltf. Ex. 9	II-R. 70	II-R. 73	II-R. 73
Pltf. Ex. 10	II-R. 70	II-R. 73	II-R. 73
Pltf. Ex. 11	II-R. 70	II-R. 73	II-R. 73
Pltf. Ex. 12	II-R. 70	II-R. 73	II-R. 73
Pltf. Ex. 13	II-R. 71	II-R. 73	II-R. 73
Pltf. Ex. 14	II-R. 71	II-R. 73	II-R. 73
Pltf. Ex. 19	II-R. 74	II-R. 74	II-R. 74
Pltf. Ex. 20A-D	II-R. 75	II-R. 75	II-R. 76
Pltf. Ex. 24	II-R. 78	II-R. 78	II-R. 79
Pltf. Ex. 25	II-R. 79	II-R. 79	II-R. 79
Deft. Ex. A	II-R. 115-116	II-R. 115-116	II-R. 116
Deft. Ex. B	II-R. 115-116	II-R. 115-116	II-R. 116
Deft. Ex. C	II-R. 115-116	II-R. 115-116	II-R. 116

9/ "II-R." refers to the Reporter's Transcript of proceedings held on November 10, 1966, and January 24, 1967.